



September 16, 2005

Members of the Investment Policy Subcommittee
California Public Employees' Retirement System
Lincoln Plaza, 400 P Street, Suite 3492
Sacramento, CA 95814

Re: Revisions to Equity Real Estate Policy;
International Equity Real Estate Policy; and Global PREES Portfolio Policy

Dear Members of the Investment Policy Subcommittee:

Pension Consulting Alliance, Inc. ("PCA") has reviewed the proposed modifications to the Equity Real Estate Policy, the International Equity Real Estate Policy and the renamed Global Public Equity Real Estate Securities ("Global PREES") Policy. In general, we think the increased allocations in the various real estate portfolios to international investments is timely given the present market conditions in the United States. As has been stated in the presentation materials, international real estate investments have the potential to provide incremental diversification benefits, but equally, if not more importantly, enhanced returns. We recognize there are certain risks associated with these investments, but believe overall that investors will be compensated on a risk-adjusted basis with superior returns.

Overall, PCA concurs with the staff recommendations. We have a few observations about the proposed modifications detailed below.

1. Technical Amendments.

Many of the staff's proposed changes to both the overall Equity Real Estate Policy and the International Equity Real Estate Policy are "clean up" modifications suggested in our prior letter dated June 10, 2005 to the Investment Policy Subcommittee. The preponderance of our comments were to clarify ambiguities between the International Equity Real Estate Policy and the overall Equity Real Estate Policy. We believe staff has done a very good job incorporating the suggested modifications, which make the two policies more consistent.

2. Mitigating Currency Risks.

The Chief Investment Officer has asked how the currency risks in these investments will be managed on an on-going basis. This issue is complicated in the private, commingled funds industry. There is no one approach that each of the fund managers use to address currency. Some international funds are U.S. dollar denominated. Some are denominated in the local currency of the country in which they will invest. Many have both U.S. dollar denominated investment pools in which investors can select to invest while simultaneously offering local currency denominated investment pools that will invest on a side-by-side basis in the same portfolio investment.

The general partners do not have consistent approaches as to how they manage the currency exposure. Some hedge the principal amount of the committed capital, but not the profits. Others hedge their entire exposure. Still others hedge dynamically, meaning that at times they hedge and at times they are completely unhedged.

One also needs to recognize that in most of the international real estate funds there are investors from around the globe who are investing in the fund in their own local currency. The general partner cannot reasonably be expected to manage currency and distributions for investors who may have differing economic interests as a result of currency fluctuations.

Consequently, it is difficult to craft a single approach that will apply to all circumstances, other than to state PCA strongly believes that CalPERS' international real estate investments should be evaluated on a U.S. dollar denominated return basis. This means that each international investment should be evaluated after converting the local currency return back into U.S. dollars, as the overall benchmark for CalPERS' composite real estate portfolio is calculated in U.S. dollars.

So, what does this suggest? We believe CalPERS needs to adopt a dynamic approach to managing the currency issue as the general partner(s) may or may not necessarily execute a currency management strategy that is in CalPERS' best interests. The general partners will presumably manage currency risks for the benefit of all their investors who may have differing interests, as well as their own interests, which may differ if they receive profit distributions in a currency other than U.S. dollars.

PCA believes the currency question should be managed on a fund by fund basis. There are a number of alternatives from which CalPERS can choose, which may change from time to time as new hedging alternatives are derived. Some include:

- a. Go unhedged. This is not an alternative PCA recommends in all instances unless other alternatives suggest this is the prudent course of conduct. For example, when the cost of hedging is so prohibitive that it would eliminate the alpha to be generated by the investment, an investor may not want to hedge. Or, if the general partner has already factored in the currency risk into the overall return requirement for the fund, they might not want to dilute the return premium by the hedging. However, as suggested above, the investment should be evaluated on the basis of the real estate return, not on the basis of a currency driven return.
- b. Hedge the capital commitment, or the principal. This strategy may make sense in many instances. In some funds, the general partner may execute this strategy. In that case, CalPERS should not pay twice for the same protection. If the general partner does not hedge the principal, CalPERS should proactively consider whether or not to hedge in some manner. CalPERS should consider whether to hedge the capital commitment over the life of the fund (which is an expensive alternative) or hedge the capital commitment as the fund begins to liquidate investments towards the end of the fund's life.
- c. Borrow the capital commitment. Borrowing in the local currency, the amount of the capital commitment to be paid back by proceeds from the fund is itself a hedge. This alternative makes a great deal of sense in a low interest rate environment.

- d. Hedge extraordinary profits. Occasionally, the general partner executes one or more transactions generating extraordinary profits that cannot be immediately distributed. One might want to reasonably “lock in the gains” and hedge out any currency risk related to those investment(s).
- e. Hire an external firm when the need arises, for example in those circumstances when the general partner does not provide this service, to manage the currency risks for those funds or have members of CalPERS internal Global Fixed Income, International & Currency Unit (“GFI Unit”) provide the service.

We believe the language in the policy in Section VI of the International Policy provides the needed flexibility to implement different hedging strategies as well as the responsibility to report the exposures to the GFI Unit.

3. Benchmarks.

PCA has discussed with the Investment Committee and staff the need for developing appropriate benchmarks for each component of the real estate portfolio. We acknowledge we need to present to the Investment Policy Subcommittee the benchmarks that will be used to monitor the International Equity Real Estate Portfolio and the Global PREES Portfolio.

There are no established benchmarks for either private international real estate investments or global real estate securities to assess the Global PREES Portfolio. However, a number of firms are presently in the process of creating benchmarks so that investors can monitor their global real estate securities portfolios.

PCA and staff are reviewing a number of potential benchmark alternatives. There are not presently appropriate benchmarks that we can identify for the Investment Policy Subcommittee. However, we recognize the need for appropriate tools to monitor performance and we will be bringing back specific recommendations as to which benchmark(s) should be adopted in the future. Subsequently, these recommendations will be brought to the Investment Committee for their review and approval.

4. Classifying all International Real Estate Investments as Non-Core.

Staff proposes, and PCA agrees, that the concept of categorizing all international investments as “non-core” should be removed from the policy. Going forward, the international policies will apply to both CalPERS’ Core and Non-Core portfolios.

5. Modifying the International Allocation Ranges.

Staff is proposing to modify the allocation ranges in two components of CalPERS real estate portfolio: the Non-Core and the Global PREES portfolios. In general, the overall limitation on international investments of the composite CalPERS’ real estate portfolio will be 50%.

The Core Portfolio is subject to a 50% limit in terms of the international allocation. Conceivably 100% of the Non-Core Portfolio could be allocated to international investments, provided that the commitments are no more than 25% of the total real estate portfolio. No more than 10% of the total real estate portfolio can be invested in any one country in this sub-portfolio. Similarly, within the Global PREES Portfolio up to 100% could be allocated to international investments, provided that no more than 25% of the composite real estate portfolio could be invested internationally.

Additionally, staff proposes to include in the policy the fact that capital allocations can be made to international commingled vehicles provided that no more than 25% of the capital commitments can be made to investments located in countries that are not on the CalPERS permissible country list, as approved by the Investment Committee in August 2005.

In our view, non-U.S. real estate investments are presently more attractive on a risk-adjusted basis than U.S. investments. PCA believes that underwriting real estate investments outside the U.S. in the near term should produce alpha relative to a U.S.-only real estate portfolio.

However, that being said, we should point out that relative to CalPERS' U.S. peers (other large public pension funds), these allocation ranges are definitely at the high end in terms of international allocations. We are not suggesting this is a reason to modify the recommendations, but we want the Subcommittee to be aware of this fact.

6. Modifications to the Global PREES Portfolio Policy

PCA has reviewed the proposed modifications to the previously domestic-only PREES portfolio. The primary changes are (i) the modification to allow the former PREES portfolio to be invested globally; (ii) the modification to use external active managers; and (iii) modifying the allocation within the Global PREES Portfolio to international real estate securities. PCA strongly supports these recommendations.

We believe that non-U.S. publicly traded real estate securities will outperform their domestic counterparts in the near term. Non-U.S. markets are experiencing a dramatic shift in the capitalization of many real estate companies and the creation of new REIT vehicles in their local markets. The situation is very much akin to the market situation in the United States in the early 1990's. At that time, there were favorable conditions allowing formerly private real estate firms to convert to public ownership. The attractive yields these securities offered attracted considerable capital flows in the early years, which helped pricing and concurrently the returns of these companies. We believe that if CalPERS commits capital at the beginning of what we perceive to be a significant market trend, CalPERS should benefit in terms of receiving outsized returns during this time period.

Staff has correctly identified a number of risk factors associated with expanding this investment strategy. However, we view the lack of liquidity and transparency, at least when compared to the United States, as potential opportunities to be exploited by talented managers. We think the concept of using active external management who can identify these inefficiencies at this juncture in the market cycle is the optimal approach to investing overseas.



We have already commented above concerning the potential changes to the allocation ranges.

We look forward to discussing these issues with the Investment Policy Subcommittee at the next meeting in September.

Very truly yours,

A handwritten signature in black ink, reading 'Nori Gerardo Lietz'.

Nori Gerardo Lietz
Managing Director

Cc: Mark Anson
Michael McCook
Al Fernandez
Randy Pottle
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